FEATURE
Location. Location. Location. Location.
Location impacts corporate income taxes
Welcome to the fourth volume of R.O.I., which showcases the bridging of UNC Kenan-Flagler’s rigorous faculty research with very real challenges faced by business leaders. We appreciate the feedback that you have sent and ask that you continue sharing your reactions and expertise.

In this issue, you will find insights about:

• Comparing the effective tax rates of publicly traded companies around the globe
• Examining whether credit default swap contracts drive changes in the equity market
• Making choices that cause firms to learn faster or to learn more
• Applying lean principles to knowledge work
• Exploring the relationship of power and status
• Choosing a branding strategy for a newly merged company

Our annual research impact conference, “The Next Generation,” will focus on “Brands and Branding in Law, Accounting and Marketing,” April 12-13. More than 100 thought leaders from industry and academia will exchange and discuss ideas at the conference, hosted in partnership with the Frank Hawkins Kenan Institute of Private Enterprise and the Center for International Business Education and Research. Please see the back cover of R.O.I. for more information.

I recently completed my term as senior associate dean for academic programs at UNC Kenan-Flagler. Demonstrating the impact of our research is a strategic priority for our School. I am confident that work will continue under the leadership of my successor, Jennifer Conrad, who is the Dalton McMichael Distinguished Professor of Finance. Her research is featured in this issue, and she will guide the direction of the magazine in the future.

Three years ago, I dreamed of the idea of a unique publication geared toward cutting edge research conducted by our faculty. Conceptualizing and creating R.O.I. have been a great experience for me. I thank Jim Dean, our dean, for his support of this vision, the faculty whose research we have featured, and our marketing and communications team for their extensive contributions in making this magazine a successful reality.

Sincerely,

Jayashankar M. Swaminathan
GlaxoSmithKline Distinguished Professor
Faculty Director of UNC-CIBER
msj@unc.edu
During a 2008 presidential campaign debate, Sen. John McCain stated, “Right now, American business pays the second-highest business taxes in the world.”

Then-Sen. Barack Obama countered: “There are so many loopholes that have been written into the tax code ... that we actually see our businesses pay effectively one of the lowest rates in the world.”

As he watched the debate, accounting professor Doug Shackelford wasn’t sure who was right.

Shackelford has spent his career studying international taxation, and he knew where he could find the answer: a new database that UNC Kenan-Flagler had just purchased provided computer-readable financial statements for thousands of firms from 83 countries around the world.

Twenty years ago, Shackelford compared the effective tax rates (ETRs) of the United States, the United Kingdom and Canada, the only countries from which data was available then. No other researcher had done anything similar since.

“Because the data had to be hand-collected, we had not been able to compare ETRs across all these different countries,” Shackelford said. “McCain and Obama had very little evidence to base their claims on. We’re trying to fill that void.”

To provide empirical underpinnings for the ongoing debates of international taxation, Shackelford and Kevin S. Markle (PhD ’10) mined the database. They compared corporate ETRs for companies in 83 countries over the past 20 years. They used regression equations to compare tax rates of multinational (MNC) and domestic firms across countries and to determine if MNCs and domestics in the same country face different tax rates.

The result is the most comprehensive analysis of firm-level corporate income taxes to date. Their paper “Cross-Country Comparisons of Corporate Income Taxes” reports their findings along with data by industry.

These findings are useful for policymakers and corporate decision-makers alike.

The question of whether the United States’ high-rate, low-base tax structure translates into high, low or average tax rates compared to other countries has long been debated. When countries compete for businesses, one tactic is to offer tax savings. A country can raise or lower its ETR by altering its tax rates or its tax base. Though the United States has not altered its rates, it has altered its base to reduce the total tax burden.

Other countries are lowering their tax burden faster than the United States, Shackelford said. However, the United States beats its competitors on many aspects that appeal to businesses, enabling it to offset possible tax disadvantages.

He is testing each company, working his way through the list. So far, his research has found evidence for all three influencing ETR, but more work is forthcoming.

“What we have done is the best attempt to compare the effective tax rates of all publicly traded companies around the globe,” said Shackelford. Corporate leaders, politicians and policymakers now have an empirical underpinning for ongoing policy debates about the taxation of multinationals.

“We provide facts to what are, by and large, people just making assertions,” Shackelford said.

**Key take-aways**

+ The location of a multinational and its subsidiaries substantially affects its worldwide ETR.
+ Multinationals based in tax havens face the lowest taxes; United States MNCs face among the highest.
+ There is little difference between the ETRs of multinational and domestic-only firms.

“The United States market far exceeds the rest of the world,” Shackelford said. “All the things that make for a huge customer market are in place: the best capital markets, the best transportation system, the most innovative researchers, the best universities – you can go down the list. If you’re a multinational, you have no option but to be in the United States, even if our corporate taxes are a bit higher than in most of the world.”

Their study also showed that tax rates vary tremendously from industry to industry in every country. In fact, their findings drew them into a political firestorm on the other side of the world. An Australian Treasury report cited figures from their paper to argue that miners were under-taxed. The ensuing debate contributed to the fall of the government and front-page coverage of their work.

In the long-standing debate over whether tax structures favor multinationals or small, independent businesses, Shackelford found no difference, on average, in a comparison of ETRs of multinationals with ETRs of companies located in only one country.

“That surprised both those who believe multinationals are treated unfairly compared with domestics and those who think that domestics are tax-disadvantaged,” he said.

Now Shackelford is delving into what causes these cross-country differences. By holding the tax rate constant, he can see variations in the tax base that might be driving the ETR. He’s studying three factors that play a role in a company’s tax burden:

+ The amount of debt a company has (because interest is deductible)
+ The extent to which a company is intangible-driven (relies on human capital more than brick-and-mortar assets)
+ The extent to which a company locates in tax havens
Recovery Rates and the Credit Crisis
The role credit default probabilities play

Jennifer Conrad is senior associate dean of academic affairs and the Dalton McMichael Distinguished Professor of Finance.
j.conrad@unc.edu

What role did credit default swaps play in the credit crisis of 2007-09? New research by finance professor Jennifer Conrad indicates you might be wrong to point fingers at the derivatives market.

Conrad has proposed a new way to estimate default probabilities. By comparing default probabilities in the credit default swap (CDS) market and equity option market, Conrad and her colleagues generated a new estimate of how asset values in firms changed through the credit crisis.

To examine if credit default swap contracts drive changes in the equity market, Conrad collaborated with Robert F. Dittmar of the University of Michigan and Alaaudeen Hameed of the National University of Singapore. They report their findings in “Cross-Market and Cross-Firm Effects in Implied Default Probabilities and Recovery Values.”

“When these estimates, we can measure the extent to which problems in financial firms had an impact on nonfinancial firms in this period – how Wall Street affected Main Street,” Conrad said.

A credit default swap is an insurance contract on a bond. If the company issuing the bond starts to struggle, the value of the insurance contract, or CDS, increases – reflecting a higher probability of default. If many people buy such insurance contracts, the price of the insurance might also increase, and market participants might infer (incorrectly) that the probability of their being in an accident was quite different. The researchers use an independent estimate of default from the equity option market that allowed them to back out the CDS’ market estimate of recovery rates and see if the rates differed across firms and changed across time.

Conrad found very strong evidence that recovery rates were different across both time and firms. “The direction of the effect wasn’t surprising,” she said, “the magnitude was.” Recovery rates declined precipitously early in the crisis, edged up in late 2008, and dropped in spring 2009. Recovery rates also differed significantly between financial and nonfinancial firms, with a much steeper decline in rates for financial firms.

Once the researchers had estimates of default probability and recovery rates, they could examine if elevated default probabilities in one firm caused changes in the default probabilities or recovery rates of other firms. For example, if one bank goes under and sells its assets under fire-sale conditions, does that affect the value of similar assets of another bank?

“If there was transmission of bad news from one bank to another,” she said, “we might be able to measure it.”

Similarly, these estimates can measure cross-effects between companies in the financial sector and nonfinancial industries. Conrad found that changes in the probability of survival of one financial firm affect other firms in that sector. And an increase in the implied default probability of financial firms leads to a decrease in the asset values of other financial firms, consistent with fire-sale effects.

Conrad and her co-authors are looking at smaller subsets of firms within the financial industry to identify how risks are propagated within the sector and if some types of financial firms have larger effects on other nonfinancial firms.

“If I measure effects across all of the big financial players,” she said, “will I find one firm, or a type of firm, that is particularly important in how its changes in probability of survival affect the other firms in that sector?”

Key take-aways

+ The CDS market does not appear to unduly drive changes in estimates of the default probability implied in the equity option market.
+ During the 2007-09 credit crisis, financial firms suffered both more dramatic decreases in their probability of survival and declines in their asset values in the event of default than did nonfinancial firms.
+ What happens on Wall Street affects Main Street, but evidence of the effect going the other way is much weaker.
First To Be Last
The long-term benefits of learning more slowly

Does your company succeed by learning faster or learning more? Researchers in the strategy field who study sustainability of advantages – the ability to make more money – tend to focus on speed and efficiency. The company that gets the product to market first wins.

So why do some firms willingly take on multifaceted, complex projects? Companies that set speed and efficiency as their goals eventually get to the same level. Why, then, do some companies perform better than the rest, year after year after year?

Strategy and entrepreneurship professor Scott Rockart gained insight while working at McKinsey & Co. as a consultant early in his career. Marvin Bower, credited as the founder of management consulting, caught his attention. And one that lends support to the overall message of his study: Working on larger projects can lead to both temporary and persistent capability advantages.

Companies that set speed and efficiency as their goals eventually get to the same level.

The strategy field examines why some firms make more money than others. Hypercompetition says that all advantages are temporary. Firms must try to go from one temporary advantage to the next. But that doesn’t explain examples of a couple of firms, particularly among investment banks, that dominate the industry for a long time. Rockart posits that those firms know something their competitors don’t, and they might have learned those advantages by taking on complex projects that pushed them to solve problems they wouldn’t have been exposed to had they taken on only projects that required simple solutions.

To test his theory, Rockart looked at differences in firms’ improvement trajectories, drawing on data in investment banking, which are primarily public. These trajectories are paths over which a firm’s capabilities develop with activity. They can be steep or gradual (the rate), and they can approach plateaus that are high or low (the potential of improvement). Other researchers have not distinguished between rate and potential or have focused on understanding differences in rate but not potential. Rockart developed an empirical model that allows the rate and potential to be estimated jointly.

The computer tablet industry faces this dilemma: Should a firm make a product quickly and efficiently that gets to market before its competitors, or should it develop a product that incorporates the latest technology and might be more useful and long-lasting once it comes on the market? The latter choice likely would involve multiple changes in the manufacturing process, which would be a significant financial setback each time. But the payoff would be a more desirable product that integrates the developing IT infrastructure in a way that no other firm’s does.

Rockart won’t speculate why in the paper, but it is a point that caught his attention. And one that lends support to the overall message of his study: Working on larger projects can lead to both temporary and persistent capability advantages.

Researchers in the strategy field who study sustainability of advantages – the ability to make more money – tend to focus on speed and efficiency. The company that gets the product to market first wins.

Rockart and Dutt saw problems with that method when it came to connecting the mathematical model with the empirical data.

“You've lost some of what's interesting about that theory in order to you're throwing out too much to get to that empirical equation. You've lost some of what’s interesting about that theory in order to make it easy to estimate how things affect learning rates.”

One result surprised Rockart: The data don’t support that taking on large, complex projects slows down a firm’s improvement rate.

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Key take-aways

Firms can make choices that cause them to learn faster or to learn more.

Advantages based on learning faster are temporary; tails will eventually catch up. Advantages from learning more may be sustained over time.

Decisions involve tradeoffs: Do you gain a competitive edge through speed or through a better product?

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Applying lean principles in service settings can be trickier. Because you’re engaged with the customer, what you’re working on can change while you’re working on it," Staats said. "Similarly, when you’re creating something new, you’re not able to specify up front what exactly you’re trying to accomplish."

Some years back, Staats connected with Wipro Technologies, the software services firm in Bangalore, India, as it began a project using lean principles. He embarked on a long-term study that compared projects using lean principles with traditionally run projects going on simultaneously at Wipro. By matching projects using lean with those that weren’t, based on similar criteria, and comparing their performance, he isolated the effect of the lean implementation as opposed to all other variables.

"We were confident that we’d see some projects function better," Staats said. "We were pleasantly surprised to see an overall improvement."

managers in the fields of consulting, product development, finance and software services are among those who have expressed interest.


The six lean principles conventionally applied to manufacturing settings that Staats saw succeed in the knowledge-work setting of Wipro can be used by managers to customize lean approaches that suit their organizations:

* Continually root out all waste.
* Strive to make tacit knowledge explicit.
* Specify how workers should communicate.
* Use the scientific method to solve problems quickly.
* Recognize that a lean system is a work in progress.
* Have leaders blaze the trail.

Those working in knowledge fields like to think that the work they’re doing is unique and irreplaceable, but they’ve been shown that breaking down the creation process into tasks and identifying the repetitive parts allow them to spend more time doing the creative parts they prefer to do.

“Following lean principles requires discipline,” Staats said. “We grow accustomed to our own way of doing things. Lean principles suggest that we need to be more structured in how we approach work, differentiating the mundane from the value-adding. That puts a level of controls on what we do, and we resist that.”

Staats’ work with Wipro is unique in several aspects. He conducted an analysis using archival data, while most studies of lean principles use survey data that asks companies what they have done. Because Wipro did a staged rollout, Staats got internal company data to compare lean projects at different stages with conventionally run projects. On top of that data, he layered many qualitative interviews — more than 100, conducted during multiple visits across several years — that rigorously established performance differences. Over the next several years, Staats returned to Wipro about every six months to track how the lean initiative evolved, giving him a deeper understanding as well as long-term perspective. Rather than evaluate only individual or team performance, he could analyze the overall change initiative.

“Our study was done across time and in depth and mixed the archival analysis with qualitative interviews,” he said.

One aspect that did not see change was quality control. The projects using lean principles had just as many software defects as the traditionally run projects. Staats said the surprising observation could be explained in a number of different ways:

* The company was meticulous and made error reduction a priority in all its projects, so it would be hard to improve more.
* Perhaps counting defects was not the right quality measure; a different sort of customer value measure might have been more appropriate.
* Maybe customers saw an improvement in something they valued that was not reflected in the data or interviews.

Many knowledge work industries struggle with the need to be more efficient. Staats’ research results are broadly applicable, even for companies that rely on work produced through complex processes.

Managers in the fields of consulting, product development, finance and software services are among those who have expressed interest.

Staats cautions that not every part of every job lends itself to lean principles.

"Be careful not to get so caught up in efficiency as a metric that you end up taking away some valuable parts of the creation process," he said. “People need time to think. But even that time can be structured so that it happens because you recognize the need to think, not because you are just waiting while other waste goes on.”

Key take-away’s

* Lean principles can improve performance in knowledge work.
* Going lean is a difficult transformation. Expect resistance.
* Identify repetitive tasks and unique ones. Use structure to do more of what customers value.
What would you do if you had the power to rule the world? Don’t even think about it unless you possess the status to go with it.

Power without concomitant status will give you nothing but grief, according to research by organizational behavior professor Alison Fragale.

“The world decides there’s only so much power you’re allowed to have,” Fragale said. “If your power and respect are out of balance, people react negatively to you, and they’ll find ways to shut you down.”

Fragale studied what happens to people who have a lot of power but are held in low regard by others. She worked with Jennifer R. Overbeck of the University of Southern California and Margaret A. Neale of Stanford University, and they published their findings in “Resources vs. respect: Social judgments based on targets’ power and status positions” in the Journal of Experimental Social Psychology in July 2011.

Psychologists rank the basic human need for power and status right up there with the need for affiliation and achievement. Though power (having the ability to control resources) and status (being held in high regard by others) often go together, they are not perfectly correlated.

Fragale, who studies hierarchies in groups, observed that people who have power without status have a hard time in their organizations. Every organization has a hierarchy, even if it minimizes its formal or informal symbols. The boss might no longer sit in a corner office on a higher floor than the rest of the staff. But at the end of the day, someone makes the final decisions.

In the first experiment, Fragale listed occupational categories – bouncers, authors, artists, professors – and asked respondents to judge the people in each occupation. Comparing those responses with the person in the occupation had and how well-regarded each person was indicated that people have well-developed schemas and mental models they use to organize their world by power and status.

Fragale’s research might be the first to peel apart power from status. It has implications for managers whose departments will run more smoothly if they give power to people who can influence others to comply. Her work also factors into negotiations. The power relationship between parties strongly influences how negotiations turn out, and the longstanding advice has been to teach people to do things that will increase their power vis-à-vis the person they’re negotiating with. But acquiring power without the status to legitimate it can backfire.

“You have to think about acquiring and wielding power in line with how other people see you,” she said. “You have to think about acquiring and wielding power in line with how other people see you.”

Fragale and her colleagues conducted two experiments that converged in telling the same story using different methods. In the first experiment, Fragale listed occupational categories – bouncers, authors, artists, professors – and asked respondents to judge the characteristics of the person in those professions and rate how much power and status they thought each person had. She found that the occupations rated similarly in power and status were rated similarly in terms of their dominance and warmth. These results indicated that people have well-developed schemas and mental models they use to organize their world by power and status.

In the second experiment, Fragale again used the occupations list. But this time she told respondents how much control over resources the person in the occupation had and how well-regarded each person was before respondents were asked to ascribe characteristics to the person in each occupation. Comparing those responses with the responses in the first experiment gave Fragale confidence that she was tapping into power and status in the first experiment.

“Previous studies show that power without status causes people to demean others. Building on that work, Fragale’s research shows that people attribute negative characteristics to high-power, low-status people, demonstrating how a vicious cycle can develop in interpersonal relationships: I expect you to be bad, so I treat you like you’re bad; you feel insecure because of that and demean me to convince yourself you are better than me; that proves to me I was right to think you’re bad.”

“Power is something people can take; status is not. ‘You don’t get to decide how much status you get,'” Fragale said.

“People will resist you and resist your attempts to influence them,” she said. “You have to think about acquiring and wielding power in line with how other people see you.”

Power is something people can take; status is not. “You don’t get to decide how much status you get,” Fragale said. “Status is a phenomenon that exists solely in the heads of others.”

In the workplace, individuals generally hold negative views of those who control resources. High status protects against these negative judgments. People will accept hard-to-swallow decisions that come from a person they highly respect. By the same token, they’ll resist decisions made by someone they hold in low regard.

Managers need to take into account an individual’s status before giving him or her additional power.

“Don’t assume a formal position guarantees that someone is granted the status as well,” Fragale said.

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Fusion – Both firms contribute elements from their separate identities to form a new brand. For instance, when United Airlines and Continental Airlines merged, they used United’s name but paired it with Continental’s logo. When J.P. Morgan and Chase Manhattan merged, they became JPMorgan Chase & Co.

Business-as-usual branding preserves the brand equity but does not seek to enhance it and does not capitalize on potential synergies. Assimilation branding discards all brand equity of the target firm, along with the embedded customers’ and employees’ goodwill. Fusion branding seeks to preserve, enhance and leverage brand equity of both merging firms. Fusion also lends itself to a more nuanced communication and messaging, its greater flexibility means it can be better tailored to suit a specific business context.

To determine which branding strategy yields the best results and under what conditions, Mizik collaborated with Isaac Dinner of IE Business School and Jonathan Knowles, CEO of Type 2 Consulting. Highlights of their study appeared in the September 2011 issue of Harvard Business Review.

The researchers studied 216 companies formed in the largest mergers between U.S.-based companies from 1997 to 2006. They separated companies into three groups based on the branding strategy each company chose. In their sample, 119 mergers used assimilation branding; 53 used business-as-usual branding; and 44 used fusion branding. The researchers examined the stock market’s immediate reaction on the day of the merger announcement for each firm and noted the average three-year postmerger return for firms in each group, relative to the market as a whole.

Mergers typically underperform the market. Surprisingly, the study found that merger performance differed significantly depending on the choice of the corporate branding by the merged firm.

Fusion branding showed the best performance overall. Unlike assimilation-branded and business-as-usual-branded mergers, fusion-branded mergers did not generate an immediate negative market reaction at the time of the merger announcement and did not show negative returns in the years after the merger was completed. Interesting differences between assimilation-branded and business-as-usual-branded mergers became apparent as well.

“We found that the stock market was better able to recognize the negative consequences of acquisition-branded mergers and to penalize the firms early on,” Mizik said. “The valuation of those firms was adjusted immediately when the merger was announced, but there was no significant underperformance after the merger was completed.”

The business-as-usual-branded mergers had only a small negative market reaction at the time of the merger announcement but showed a significant postmerger drop in valuation. “The investors seemed to appreciate the clarity of the assimilation and fusion strategies,” Mizik said, “but they tended to have difficulty properly pricing the business-as-usual-branded mergers and overvalued them initially.”

After adjusting for such factors as risk, size and market-to-book ratio, Mizik found that, three years from the day of the merger announcement, companies using an assimilation branding strategy fell short of the market return by 15 percent on average. Companies using a business-as-usual approach fell short by 25 percent. But fusion-branded companies exceeded the market return by 3 percent.

Mizik’s research is the first to systematically examine the value implications of corporate branding strategies in mergers and to document the differences in performance across fusion-branded, assimilation-branded and business-as-usual-branded mergers. Assimilation and business-as-usual branding strategies might be more expedient but are associated with inferior performance compared to fusion branding.

Given the continuing popularity of mergers as a component of corporate growth strategy, Mizik’s insights are all the more relevant. Effective branding can help the merged entity enhance or preserve brand equity and customer equity of the merging companies. It can expand the appeal of the entity’s products to new segments and generate new incremental value to customers and employees through improved image and better marketing of products. Investors might use branding strategy as an indication of how well the companies have thought through the merger transaction and integration. It signals the strategic direction and vision, managerial intent and commitment to successful integration.

Managers should be more deliberate in evaluating the options and selecting branding strategies, said Mizik. “Corporate branding can help mitigate some of the uncertainty caused by clarifying the intention of the merger to customers, employees and investors – the three key constituencies whose ongoing loyalty largely determines the merger’s success or failure.”

Key take-aways

- Branding affects customers, employees and investors. The reaction and the ongoing loyalty of these constituencies determine the financial success of a merger.
- Firms using acquisition and business-as-usual branding strategies underperform those using fusion branding.
- Acquisition branding is penalized immediately at the time of the merger announcement, while business-as-usual branding has only a small initial penalty. But in the postmerger period, firms using business-as-usual branding perform worse than those using acquisition branding.
Our annual research impact conference, “The Next Generation,” will focus on “Brands and Branding in Law, Accounting and Marketing,” April 12-13, at UNC Kenan-Flagler. Senior business leaders and prominent scholars who specialize in branding, intellectual property and brand-related taxation and transfer pricing concerns will examine and discuss critical issues related to intangible assets and intellectual property created by marketing.

The goal of the conference is to ignite a dialogue about the views and treatment of brands inside the marketing discipline, as well as outside of the marketing field, and to provide direction for marketing academics to address relevant research questions.

“The Next Generation” is a program of the Frank Hawkins Kenan Institute of Private Enterprise and the Center for International Business Education and Research at UNC Kenan-Flagler.

www.kenaninstitute.unc.edu/nextGen/Marketing